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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE DIVISION

SECURITIES AND EXCHANGE
COMMISSION,

14 Plaintiff,

15 vs.

16 MARK LESLIE, et al.,

17 Defendants.

Civil Action No. C 07-3444 JF

**PLAINTIFF SECURITIES AND
EXCHANGE COMMISSION'S
COMBINED OPPOSITION TO
DEFENDANTS LESLIE'S, LOCHAR'S
AND SALLABERRY'S MOTIONS TO
DISMISS THE COMPLAINT AND
MOTIONS TO STRIKE**

Date: January 18, 2008

Time: 9:00 a.m.

Location: Courtroom 3, 5th Floor
Hon. Jeremy Fogel

PLAINTIFF SECURITIES AND EXCHANGE
COMMISSION'S COMBINED OPPOSITION TO
DEFENDANTS' MOTIONS TO DISMISS AND/OR
MOTIONS TO STRIKE
SEC v. MARK LESLIE, et al., Civil Action No. C 07-
3444 -JF

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1 Plaintiff Securities and Exchange Commission (the “Commission” or “SEC”) respectfully
 2 submits this combined opposition to defendants Mark Leslie’s, Kenneth E. Lonchar’s, and Paul A.
 3 Sallaberry’s motions to dismiss under Fed. R. Civ. P. 12(b)(6) and 9(b) and Leslie’s and Sallaberry’s
 4 motions to strike under Fed. R. Civ. P. 12(f).

5 While the three defendants filed three separate motions and briefs, with numerous exhibits,
 6 each endeavoring to advance a myriad of arguments for dismissal or striking with prejudice, the
 7 defendants’ submissions boil down to the following: (1) that the Commission’s Complaint does not
 8 plead the federal securities violations against each of the defendants with particularity; and (2) that
 9 certain of the remedies that the Commission seeks against each of the defendants in its Complaint are
 10 time-barred.

11 As shown below, the defendants’ arguments have no merit. The Commission’s well-pled
 12 Complaint has sufficiently alleged the claims to withstand any motion to dismiss or motion to strike.
 13 The Commission has set forth *scienter*-based violations (fraud claims) against each of the defendants
 14 with the required particularity under Fed. R. Civ. P. 9(b) and the applicable Ninth Circuit precedents.
 15 Even in the non-*scienter* based violations (non-fraud claims) against the defendants, where Rule 9(b)
 16 particularity is not required, the Commission has nonetheless alleged the violations with
 17 particularity. The Commission’s Complaint adequately identifies the circumstances of the fraud so
 18 that the defendants can prepare an adequate answer.

19 To be sure, recognizing that the Commission’s Complaint amply satisfies Fed. R. Civ. P. 9(b)
 20 and the applicable Ninth Circuit precedents, the defendants attempt to impermissibly impose
 21 additional, non-applicable pleading requirements: under the Private Securities Litigation Reform Act
 22 (“PSLRA”), which does not apply to the Commission’s enforcement actions such as this one; under
 23 the more stringent standards outside the Ninth Circuit; or under the theory that the Commission,
 24

1 because of its administrative investigatory powers, should be held to a higher pleading standard
 2 beyond the Ninth Circuit's 9(b) requirements. These arguments should be rejected.

3 Moreover, the Commission's requests for remedies against each of the defendants are, as a
 4 matter of law, available and not time-barred under the Ninth Circuit standard in *SEC v. Rind*, 991
 5 F.2d 1486 (9th Cir. 1993), which none of the defendants cites even once, and other persuasive
 6 authorities. Put another way, the Commission, acting in its sovereign capacity enforcing securities
 7 laws, is not subject to the same time-bars as a private plaintiff.

8 To the extent that there are factual or legal issues on the timeliness of any remedy sought by
 9 the Commission, those issues, which the Commission contends will be resolved in its favor after
 10 discovery, should not be prematurely resolved at this pleading stage where there has been no
 11 showing of prejudice by the defendants.

12 Accordingly, the defendants' motions should be denied in their entirety.

13 **ISSUES TO BE DECIDED**

14 1. Whether the *scienter*-based fraud violations (part of the First and the Second Claims
 15 of the Complaint) against Leslie, Lonchar, and Sallaberry meet the applicable pleading standards
 16 under Fed. R. Civ. P. 9(b) and 12(b)(6).

17 2. Whether the non-*scienter* based securities violations (part of the First, the Third and
 18 the Fifth Claims) against Leslie, Lonchar, and Sallaberry, even assuming *arguendo* that Rule 9(b) is
 19 applicable to those violations, meet the pleading standards under Rule 12(b)(6).

20 3. Whether the aiding and abetting violations (part of the Fourth Claim) against Lonchar
 21 and the aiding and abetting violations (the Sixth Claim) against Leslie, Lonchar, and Sallaberry,
 22 even assuming *arguendo* that Rule 9(b) is applicable to those violations, meet the pleading standards
 23 under Rule 12(b)(6).

1 4. Whether the materiality element with respect to the AOL transactions has been
 2 sufficiently alleged.

3 5. Whether any of the remedies challenged by Leslie, Lonchar, and Sallaberry should be
 4 stricken under Fed. R. Civ. P. 12(f) or dismissed under Fed. R. Civ. P. 12(b)(6) as time-barred.

5 **STATEMENT OF THE CASE**

6 **I. Procedural History**

7 The Commission filed its Complaint against, among others, defendants Leslie, Lonchar, and
 8 Sallaberry on July 2, 2007.¹ The Commission and Leslie, Lonchar, and Sallaberry have exchanged
 9 their respective Rule 26 Initial Disclosures, and the Commission has produced documents and
 10 electronic databases to the three defendants pursuant to Fed. R. Civ. P. 26(a). On October 5, 2007,
 11 this Court held an Initial Case Management Conference, at which the Court held in abeyance any
 12 setting of the discovery schedule, including when fact depositions may begin, or the trial date until a
 13 hearing on January 18, 2008.

14 **II. The Complaint's Allegations**

15 The Complaint alleges that Mark Leslie was the Chief Executive Officer (“CEO”) and
 16 Chairman of the board of directors of Veritas Software Corporation (“Veritas”), a publicly-held
 17 software company in Cupertino, California. Complaint (“Compl.”) ¶¶ 1, 9, 14. Leslie resigned as
 18 Veritas’ CEO on December 31, 2000, but continued to serve on its board of directors until May 31,
 19 2004. Compl. ¶ 9. Leslie profited by selling Veritas stock at prices inflated by the misstatement of
 20 the revenue related to the AOL transaction and by receiving a bonus from Veritas based on Veritas’
 21 artificially inflated financial results. Compl. ¶ 81.

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 27 1 The other two defendants named in the Complaint, Michael M. Cully and Douglas S. Newton, have
 28 already settled with the Commission, and this Court entered final judgments as to them on August 2,
 2007.

1 Kenneth E. Lonchar was Veritas' Chief Financial Officer ("CFO") from April 1997 until
 2 October 2002. Compl. ¶ 10. Lonchar was licensed as a Certified Public Accountant ("CPA") in
 3 Idaho. *Id.* Lonchar profited by selling Veritas stock at prices inflated by the misstatement of the
 4 financial statements and by receiving a bonus from Veritas based on Veritas' artificially inflated
 5 financial results. Compl. ¶ 82.

6 Paul A. Sallaberry was Veritas' executive vice president of Worldwide Field Operations from
 7 January 2000 through January 2003. Compl. ¶ 11. Sallaberry was Veritas' head of sales. Compl. ¶
 8 2. Sallaberry profited by selling Veritas stock at prices inflated by the misstatement of the revenue
 9 related to the AOL transaction and by receiving a bonus from Veritas based on Veritas' artificially
 10 inflated financial results. Compl. ¶ 81.

12 Leslie, Lonchar, and Sallaberry knowingly participated in a fraudulent scheme by artificially
 13 inflating Veritas' publicly reported revenues and earnings through a round-trip transaction with
 14 America Online, Inc. ("AOL") in 2000 and by lying to Veritas' outside auditors. Complaint
 15 ("Compl.") ¶ 1. Further, Lonchar, with the participation and assistance of two other co-defendants,
 16 Michael M. Cully and Douglas S. Newton, intentionally manipulated and distorted Veritas' reported
 17 earnings through "smoothing" its financial results from at least 2000 through 2002 and that Lonchar
 18 lied to and/or failed to disclose to Veritas' outside auditors their fraudulent conduct. Compl. ¶ 1.
 19 As a result of the defendants' actions, Veritas reported materially false and misleading financial
 20 results in periodic reports filed with the Commission and other public statements from at least 2000
 21 through 2003 and in its January 28, 2004 earnings release of fourth quarter and annual results for
 22 2003. Compl. ¶ 4.

23 **A. The AOL Transaction**

24 The Complaint alleges that in 2000, Veritas artificially inflated reported revenues by
 25 approximately \$20 million in connection with a software sale to AOL. Compl. ¶ 2. Leslie
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1 authorized the transaction and directed Sallaberry to negotiate the terms and execute the transaction
 2 documents. *Id.* Lonchar applied an accounting treatment to the transaction that did not comply with
 3 generally accepted accounting principles (“GAAP”). *Id.* All three defendants – Leslie, Sallaberry,
 4 and Lonchar -- concealed the true nature of the AOL transaction, which allowed Veritas to artificially
 5 inflate its reported revenue, from Veritas’ outside auditors. Compl. ¶¶ 2, 50.

6 **1. Leslie and Sallaberry agreed to the AOL round-trip transaction and Lonchar**

7 **improperly booked the revenue from the transaction:** During the summer of 2000, Veritas began
 8 negotiating with AOL to sell an unlimited license for all of Veritas’ software products as well as
 9 certain service, consulting and training commitments (the “License”). Compl. ¶ 16. Veritas’ sales
 10 personnel, under Sallaberry’s direction and supervision, handled most of the License negotiations.
 11 *Id.* During negotiations in late August and September 2000, AOL proposed that Veritas purchase
 12 online advertising from AOL. Compl. ¶ 17. At the time, Veritas had no budget or need for AOL’s
 13 online advertising and rejected the proposal. *Id.*

14 By mid-September 2000, AOL and Veritas had agreed on a \$30 million purchase price for the
 15 License, which represented a 65% discount. Compl. ¶ 18. Veritas and AOL agreed to close the
 16 transaction by the end of the third quarter (September 30, 2000). *Id.* The \$30 million transaction
 17 was the largest transaction in Veritas’ history. Compl. ¶ 19.

18 On September 29, 2000, just hours before Veritas and AOL were set to execute the License
 19 agreement, AOL’s lead negotiator telephoned Leslie and asked, as a favor, for Leslie to allow AOL
 20 to pay an additional \$20 million for the license and Veritas’ agreement to purchase a comparable
 21 amount of AOL online advertising. Compl. ¶ 20. The AOL negotiator explained that AOL would
 22 simply take a “shallow” (less favorable) discount on the license. *Id.* Based upon his discussion
 23 with AOL’s lead negotiator, Leslie understood that AOL was asking to pay a higher price for the
 24 same license. *Id.*

1 Leslie agreed to the proposal, even though Veritas did not need or want millions of dollars of
 2 online advertising from AOL. Compl. ¶ 21. At the time, Leslie had never purchased online
 3 advertising and had no idea if Veritas had a campaign in place to use the advertising. *Id.*

4 After his telephone conversation with AOL on September 29, 2000, Leslie directed
 5 Sallaberry to contact AOL to work out the details of the transaction. Compl. ¶ 22. Leslie told
 6 Sallaberry that the License was not to be changed in any way that would increase the real, out-of-
 7 pocket costs to Veritas. *Id.*

8 That same day, Sallaberry then telephoned a sales executive at AOL to effectuate the
 9 agreement. Compl. ¶ 23. The AOL sales executive repeated the proposal previously made to
 10 Leslie: that AOL would pay Veritas \$50 million for the License, instead of \$30 million, if Veritas
 11 would buy \$20 million of online advertising from AOL. *Id.* Sallaberry affirmed the AOL proposal,
 12 after consulting with Lonchar and Leslie. Compl. ¶ 23. The terms of the License remained
 13 essentially unchanged despite the \$20 million increase in the price. *Id.*

14 Nonetheless, that same day, Lonchar told Sallaberry to document the transaction as if it were
 15 two separately negotiated, *bona fide* contracts. Compl. ¶ 25. Moreover, despite his knowledge of
 16 the true nature of the AOL transaction, Lonchar improperly booked the entire \$50 million as license
 17 and service revenue beginning in the fourth quarter of 2000 through 2002. Compl. ¶ 30. Lonchar's
 18 accounting for the transaction did not conform to GAAP. *Id.*

19 Sallaberry, who had no marketing experience, reviewed and executed the AOL advertising
 20 purchase – the largest in Veritas' history – without consulting anyone in the marketing department.
 21 Compl. ¶ 24. Sallaberry did not try to negotiate any terms of AOL's standard form advertising
 22 contract, notwithstanding Veritas' \$20 million lump-sum payment for advertising, \$6.6 million of
 23 which was to begin running within a matter of days. *Id.* The advertising contract gave AOL
 24 complete discretion as to where the advertising would be run. *Id.*

1 Still that same day, Sallaberry executed on behalf of Veritas both a contract to sell the
 2 license to AOL for \$50 million and a contract to buy \$20 million of online advertising from AOL.
 3 Compl. ¶ 25. The license provided for payment within 30 days from the date of invoice while the
 4 advertising agreement required payment within 30 days of the contract date – typical payment terms
 5 for each company. Compl. ¶ 26. Sallaberry and his AOL counterpart, however, verbally agreed to
 6 make simultaneous wire payments of their respective amounts due. *Id.* Sallaberry did not document
 7 this agreement. *Id.*

8 On October 2, 2000, Leslie revealed the true nature of the transaction in an email
 9 correspondence, explaining: “We closed a \$30 million deal with AOL (which will be taken to
 10 revenue in Q4). However, at the eleventh hour we got a request from AOL to gross up the deal by
 11 \$20 million and take back an equal amount of dollars in paid advertising to AOL.” Compl. ¶ 27.
 12

13 In early October 2000 and in response to Leslie’s email, he was warned at least twice of the
 14 “sensitive” accounting issues arising from the AOL transaction. Compl. ¶ 28. Leslie was urged to
 15 take extra caution in making sure the company’s outside auditors agreed with the Company’s
 16 revenue recognition for the AOL transaction. *Id.*

17 In November 2000, when Veritas’ \$20 million payment pursuant to the terms of the
 18 advertising contract was due, AOL had not yet paid the \$50 million under the license. Compl. ¶
 19 29. Sallaberry insisted that Veritas hold AOL to his verbal agreement with AOL that these
 20 payments be made by simultaneous wire transfers. *Id.* On December 1, 2000, Sallaberry and
 21 Lonchar were told the companies made these simultaneous wire transfer payments that day. *Id.*

22 **2. Leslie, Sallaberry and Lonchar then lied to and withheld material information**
 23 **from Veritas’ outside auditors about the AOL transaction and obtained an unqualified audit**
 24 **report on the 2000 financial statements from the auditors:** In December 2000, Veritas’ outside
 25 auditors reviewed the license as part of their regular review of significant revenue transactions for
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1 the fourth quarter of 2000. Compl. ¶ 31. Lonchar and Sallaberry did not disclose to the auditors the
 2 contingent nature of the advertising deal – namely, that Veritas only agreed to enter into the
 3 advertising contract after AOL agreed to fund that “purchase” by inflating the price of the License.

4 *Id.* As a result, the auditors reviewed and treated the License as a “stand-alone” revenue contract.

5 *Id.*

6 In January 2001, during its audit, Veritas’ outside auditors discovered the concurrent nature
 7 of the contracts with AOL and questioned whether Veritas could recognize revenue on the License in
 8 the amount of \$50 million. Compl. ¶ 32. To determine whether Veritas could substantiate its
 9 accounting for the contracts at their gross amounts, the auditors spoke to Leslie, Sallaberry, and
 10 Lonchar to understand the business rationales behind the contracts and justify the prices paid. *Id.*
 11 Leslie, Sallaberry, and Lonchar each knowingly failed to inform the outside auditors of the true,
 12 contingent nature of the AOL contracts, including the last-minute negotiations that resulted in the
 13 \$20 million inflation of the License price and \$20 million advertising deal. Compl. ¶ 33.

14 Thus, the outside auditors, based upon the false representations made by Leslie, Lonchar, and
 15 Sallaberry, ultimately issued an unqualified audit report on the 2000 financial statements. Compl. ¶
 16 48.

17 a. **Leslie misrepresented to the auditors:** When the outside auditors discovered the
 18 license and advertising contract were executed on the same day, they required that additional
 19 procedures be performed. Compl. ¶ 37. The auditors informed Leslie of the accounting literature
 20 on point, made inquiries regarding the substance of the transactions, and explained to him the
 21 accounting issues implicated by the transactions. *Id.*

22 Leslie did not ask whether Lonchar had discussed or cleared the accounting with the auditors.
 23 Compl. ¶ 38. Instead, Leslie falsely represented to the auditors, among other things, that: (1) the
 24 two AOL contracts were entered into for separate and valid business reasons; (2) the AOL software

1 sale and advertising purchase were separate and not part of any overall arrangement between the two
 2 companies; (3) AOL's commitment to pay the fee for the license was, from its initiation, never
 3 contingent upon Veritas entering into the advertising purchase; (4) Veritas needed this online
 4 advertising as part of its campaign for stronger brand recognition; and (5) the contracts were fairly
 5 priced at \$50 million and \$20 million, respectively. *Id.*

6 Leslie did not disclose to the outside auditors the contingent nature of the contracts, including
 7 the last-minute negotiations that resulted in the \$20 million inflation of the License price and \$20
 8 million advertising deal, or his role in the negotiations. Compl. ¶ 38 .

10 During the January 2001 audit committee meeting at which the AOL transaction was
 11 discussed with the outside auditors, Leslie again failed to inform the auditors of the contingent nature
 12 of the software sale and advertising purchase and the last-minute negotiations that resulted in the \$20
 13 million inflation of the License price and \$20 million advertising deal as well as his role in the
 14 negotiations. Compl. ¶ 46 .

16 b. **Sallaberry misrepresented to the auditors:** In January 2001, Sallaberry played a
 17 critical role in deceiving the outside auditors about the two contracts he signed with AOL. Compl. ¶
 18 38 . As part of Veritas' effort to justify its accounting for the AOL contracts, Sallaberry (1) lied to
 19 and misled the outside auditors in discussions with the audit team; (2) participated in, or at least was
 20 aware that others were, altering or withholding documents created contemporaneously with the
 21 transaction that described it as a \$30 million license at a 65% discount and directed the creation of
 22 documents to support the \$50 million price and 42% discount as being fair and reasonable; and (3)
 23 interceded with AOL to have his AOL counterpart sign an audit confirmation for Veritas' outside
 24 auditors in time for Veritas' earnings release. *Id.*

26 Sallaberry spoke with Veritas' outside auditors about the sales process preceding the license
 27 agreement, the overall business context for the transaction with AOL, the reason for the size of the
 28

1 license, the discount percentage, the business reasons and scope of the transaction and AOL's
 2 expected deployment of the software. Compl. ¶ 40. The auditors also asked Sallaberry whether the
 3 size and scope of the transaction was comparable to prior transactions. *Id.* Instead of being truthful,
 4 Sallaberry provided false and misleading responses. *Id.*

5 In particular, when a member of the audit team asked Sallaberry whether the software sales
 6 transaction was contingent upon or connected to the advertising arrangement, Sallaberry falsely
 7 represented that it was not. Compl. ¶ 41. Sallaberry concealed the contingent nature of the
 8 advertising deal by falsely claiming that the marketing department, not Sallaberry, negotiated the
 9 advertising deal. Compl. ¶ 42. Sallaberry did not disclose to Veritas' outside auditors the last
 10 minute negotiations that resulted in the \$20 million inflation of the License price and \$20 million
 11 advertising deal. Compl. ¶ 43. Instead, Sallaberry participated in the preparation of and submission
 12 to Veritas' outside auditors of documents that justified the \$50 million License price and concealed
 13 the true nature of the AOL transaction. Compl. ¶ 45. Sallaberry directed his sales team to collect
 14 documentation to falsely support the value of the license at \$50 million and a 42% discount. Id.
 15

16 Sallaberry did not disclose to the auditors that he and his AOL counterpart agreed to make
 17 payments under the contracts by simultaneous wire transfers, contrary to the express terms of the two
 18 agreements, and that he later insisted that payments be made simultaneously when AOL pressed for
 19 Veritas' payment on the stated contract terms. Compl. ¶ 44.

20 **c. Lonchar misrepresented to the auditors:** Lonchar lied to Veritas' auditors, telling
 21 them: (1) the License and the advertising contract were entered into for separate and valid business
 22 reasons and were not part of any overall arrangement; (2) the transactions were separately negotiated
 23 by executives in different functional organizations within Veritas; (3) both contracts were fairly
 24 valued; (4) Veritas entered into the advertising contract in order to strengthen brand name
 25 recognition; and (5) AOL's commitment to pay the License fee was never contingent on Veritas
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